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No. 01-___

IN THE

Supreme Court of the United States

Del Commercial Properties, Inc.,
Petitioner,

v.

Commissioner of Internal Revenue.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the District of Columbia Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Did the D.C. Circuit err in holding, in square conflict with the Seventh and Eleventh Circuits, that the form of a transaction will be disregarded for tax purposes whenever the taxpayer "could have achieved its objective more directly, but instead included [a] step for no other purpose than to avoid U.S. taxes," notwithstanding that the transaction involves a bona fide entity, furthers a bona fide business purpose, and falls within the terms of a U.S. tax treaty?

PARTIES TO THE PROCEEDINGS BELOW

The parties to the proceedings below are identified in the caption.

RULE 29.6 STATEMENT

Petitioner's parent corporation is Delcom Holding Limited, an Ontario Corporation. No publicly held company owns ten percent or more of Petitioner's stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Del Commercial Properties, Inc., respectfully petitions for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in this case.

OPINIONS BELOW

The Tax Court's opinion (Pet. App. 15a-24a) is available at T.C. Memo 1999-411. The D.C. Circuit's opinion (Pet. App. 1a-14a) (per Sentelle, J., joined by Tatel and Garland, JJ.) is published at 251 F.3d 210.

RELEVANT STATUTORY PROVISIONS

The Appendix (at 25a-26a) reproduces the relevant provisions of the Internal Revenue Code and the version of the U.S.-Netherlands treaty applicable to this case.

JURISDICTION

The court of appeals entered its judgment on June 8, 2001. The Chief Justice subsequently extended the time to file this Petition to and including October 26, 2001. Applic. No. A01-176. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATEMENT

This case presents a fundamental question of tax law, central to both domestic and international tax planning, that has split the circuits. The Seventh and Eleventh Circuits, applying precedents of this Court dating to the 1930s, hold that taxpayers have the right to structure transactions to minimize their tax liability, including by utilizing bona fide intermediaries. Taxpayers are thus free to avail themselves of provisions not only of the domestic tax laws, but also of tax treaties negotiated by the President and approved by the Senate that provide benefits to U.S. taxpayers contracting with citizens of our treaty partners as intermediaries.

The D.C. Circuit, by contrast, held in this case that such an intermediary's role in a transaction will be disregarded whenever a "taxpayer could have achieved its objective more directly, but instead included [a] step for no other purpose than to avoid U.S. taxes." Pet. App. 6a. The court thereby stripped a bona fide transaction consummated by Petitioner – which included the use of a Dutch intermediary – of the benefit of the U.S.-Netherlands tax treaty. That decision not only conflicts directly with the holdings of the Seventh and Eleventh Circuits, but also undermines the ability of our nation to make good on its solemn treaty commitments.

1. In 1990, Petitioner Del Commercial Properties ("Taxpayer" or "Petitioner") determined that it would need a loan to finance its ongoing operations. Taxpayer is an Illinois corporation that manages commercial properties in the United States. Taxpayer's principal place of business is in Canada, and it is a member of an affiliated group of principally Canadian companies.

Taxpayer received the loan it needed from a Dutch financing subsidiary of the affiliated group, Del Investments Netherlands, B.V. ("Del BV"), and made interest payments on the loan. Although a U.S. taxpayer generally owes a thirty-percent tax on interest payments made to foreign entities not connected with a trade or business in the U.S. (see 26 U.S.C. §§ 871, 881), that rule is superceded by applicable tax treaties between the United States and other nations (*id.* § 894).[1] Under the U.S.-Netherlands tax treaty, which was adopted in order to avoid double taxation, U.S. taxpayers are not subject to U.S. tax on their interest payments to Dutch corporations, which payments are instead taxable in the Netherlands. See Convention With Respect to Taxes on Income, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855 (*extended to* the Netherlands Antilles

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[1] The tax is formally owed by the foreign entity but must be withheld and paid by the U.S. taxpayer. See 26 U.S.C. §§ 1441, 1442, 1461. See generally Pet. App. 5a-6a (describing the statutory scheme).

by Protocol June 15, 1955, 6 U.S.T. 3696, T.I.A.S. No. 3366; *amended by* Protocol, Oct. 23, 1963, 15 U.S.T. 1900, T.I.A.S. No. 5565; *modified by* Convention, Dec. 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051); cf. PHILIP F. POSTLEWAITE, INTERNATIONAL CORPORATE TRANSACTIONS § 4.01 (1980) ("[M]any nations have entered into bilateral agreements or conventions with other trading nations in order to limit double taxation effects."). Indeed, Del BV duly reported the interest income on its tax returns and Taxpayer did not.

2. The Commissioner of the Internal Revenue Service ("Commissioner" or "Respondent") took the position that the U.S.-Netherlands tax treaty did not apply to the transaction. Rather, it asserted that Del BV's role in the transaction should be disregarded under the so-called "step-transaction doctrine" and that (arguing that the interest payments were in substance paid to a Canadian entity) the interest should be taxed at the fifteen-percent rate set by the U.S.-Canada tax treaty. See Convention on Taxes on Income and Capital, Sept. 26, 1980, U.S.-Canada, T.I.A.S. No. 11087, Art. XI. Together with penalties and additions, the Commissioner assessed a deficiency of approximately $1,200,000.

The Tax Court agreed with the Commissioner, holding that Taxpayer had engaged in "a step transaction" because Del BV "acted as a mere shell or conduit with respect to the interest payments Del Commercial made." Pet. App. 23a. The Tax Court pointed to the fact that the funds that Del BV loaned to Taxpayer originated with a bank borrowing by a related Canadian entity. In addition, Del BV had received the funds as a capital contribution but immediately loaned them to Taxpayer without exercising any further "control." *Id.* 22a. The Tax Court stated that Del BV itself engaged in "minimal business activity" with its "minimal assets" other than the loan to Taxpayer. *Id.* 22a-23a.

The Tax Court also identified a "link between the loan payments [Taxpayer] made [to Del BV] and the [Canadian] loan." Pet. App. 23a. Taxpayer had issued "guaranties" that

the Canadian loan would be repaid. In addition, according to the Tax Court, for the first half of the tax period in question, Del BV effectively transferred the payments it received from Taxpayer to a Canadian affiliate, which used them to pay the Canadian loan. For the latter half of the tax period, in order to provide the Canadian lender greater security, Del BV directed Taxpayer to skip Del BV and pay the Canadian affiliate directly. *Id.*

The Tax Court separately concluded that "the participation of Del [BV] had no purpose other than avoidance of withholding tax." *Id.* 23a.

3. The D.C. Circuit affirmed based on the Tax Court's conclusion that the only purpose for structuring the loan to include Del BV was to avoid U.S. tax. According to the court of appeals, Taxpayer bore "the burden of proving that Del BV was in substance the real lender for tax purposes." Pet. App. 8a. The court held, moreover, that

> [u]nder the step-transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes. In step-transaction cases, the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive.

Id. 6a (citing *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609 (1938)) (additional citation, quotation marks, and alteration omitted). See also *id.* 7a (finding persuasive two revenue rulings providing that "if the sole purpose of a transaction with a foreign corporation is to dodge U.S. taxes, [a] treaty cannot shield the taxpayer from the fatality of the step-transaction doctrine").

The court of appeals first addressed the period in which Taxpayer, at the direction of Del BV, made interest payments directly to its Canadian affiliate. Although the Tax Court had merely found those payments to be evidence of the "link"

between the Canadian and Dutch loans (Pet. App. 7a), the court of appeals went further. Because "[t]he U.S.-Netherlands Tax Treaty does not apply to direct transactions between a U.S. corporation and a Canadian corporation," the court held as a matter of law that Taxpayer should have paid tax on the interest during this period. *Id.* The court of appeals made no mention of the "assignment of income doctrine," under which income is attributed to its owner notwithstanding that the owner directs that the income will be assigned to a third party.

Regarding the remainder of the tax period, the D.C. Circuit found that Del BV's role should be disregarded under the step-transaction doctrine because its only purpose in the transaction was to trigger the U.S.-Netherlands tax treaty and thereby avoid U.S. tax.[2] Accordingly, Taxpayer had "not shown that Del BV served any role with a sufficient business or economic purpose to overcome the conduit nature of the transaction." Pet. App. 8a (citation and quotation marks omitted). The court of appeals specifically found that there was not sufficient evidence that the transaction provided the affiliated group with Canadian tax savings. *Id.* 8a-10a.[3]

The D.C. Circuit's exclusive reliance on the "purpose" for utilizing Del BV in the transaction left no room for the court to consider a number of undisputed characteristics of the loan transaction, Del BV's operations, and Del BV's relationship to Taxpayer –

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[2] Like the Tax Court, the court of appeals concluded that several facts showed a "nexus" between the Canadian and Dutch loans: the interest rates and repayment schedules "closely correspond"; Taxpayer had issued guaranties on the Canadian loan; and during the latter half of the loan, Taxpayer had paid the Canadian affiliate directly. Pet. App. 8a.

[3] For purposes of this Petition, Taxpayer accepts that it structured the loan in this case so that it would be issued from the Netherlands rather than from Canada in order to trigger the protections of the U.S.-Netherlands tax treaty.

Regarding the loan itself: Taxpayer secured the funds in question as part of its bona fide, ongoing operations, and not in an effort to avoid U.S. tax. *E.g.*, Pet. App. 17a (Tax Court's finding that Taxpayer secured loan because it "needed funds to refinance and to make improvements to some of its real property located in the United States"). In addition, each payment made by Taxpayer directly reduced its assets.

Regarding Del BV's operations: Del BV was a bona fide financing entity that existed entirely independent of this transaction and that was not in any respect controlled by Taxpayer. Even accepting the Tax Court's characterization (Pet. App. 18a, 22a-23a), Del BV engaged in "minimal business operations." See also, *e.g.*, Stip. of Facts ¶¶ 115 ("During 1992, the Barbados Branch of Del BV made loans or advances to Tridel Corporation."), 121 ("Del BV had made loans to Groomsman I, Inc. in the amount of $912,417 (U.S.) and to Delcom Cayman, Ltd., in the amount of $11,700 (U.S.) as of June of 1991.").

Regarding the relationship between Del BV and the loan payments: Del BV formally had control over the funds it received from Taxpayer, and (for a substantial period) received interest from Taxpayer at a rate one-and-a-half percent higher than was owed on the Canadian loan. Also, since Del BV received its funds through a contribution to capital, it owed no money on any loan relating to this transaction.[4]

REASONS FOR GRANTING THE WRIT

The courts of appeals flatly and avowedly disagree about the scope of the step-transaction doctrine. This case squarely presents the one issue that is most central to that disagreement

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[4] The Tax Court and D.C. Circuit both sustained the imposition of penalties and additions against Taxpayer. Pet. App. 12a-14a, 23a-24a. Taxpayer does not address that issue further because, if this Court were to reverse the finding of tax liability it would, *a fortiori*, reverse the imposition of penalties and additions.

in the corporate context: in what circumstances may taxpayers use bona fide intermediaries to shield transactions from taxation? The D.C. Circuit held that "a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes." Pet. App. 6a. The Seventh and Eleventh Circuits flatly reject that rule as contrary to this Court's holding in *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935), that, because taxpayers have the right to minimize "or altogether avoid" taxes, tax liability may not be made to depend on the taxpayer's intent in structuring a transaction to minimize, or eliminate, such liability. If presented with this case, the Seventh and Eleventh Circuits would rule for Taxpayer because they recognize an intermediary's role so long as the intermediary and the broader transaction in which the intermediary plays a role are bona fide.

The correct answer to the question presented has the potential to affect almost every substantial commercial transaction and furthermore directly affects the federal government's treaty obligations. A basic premise of modern corporate finance is the use of numerous steps and/or intermediaries in a transaction with an underlying commercial purpose in order to reduce or eliminate tax liability. The D.C. Circuit's decision, however, calls that premise squarely into question by refusing tax recognition whenever a business "could have achieved its objective more directly" but included a step "for no other purpose" than to avoid tax. That principle may cripple tax planning. Furthermore, by employing a common law domestic tax doctrine to deny recognition to a transaction otherwise encompassed by the plain language of a tax treaty negotiated by the President and ratified by the Senate, the D.C. Circuit's decision threatens the nation's compliance with its international commitments.

I. The Decision Below Conflicts With The Precedents Of Other Circuits And With This Court's Holding That An Intent To Avoid Taxes Is Not Sufficient To Trigger The Step-Transaction Doctrine.

The lower courts have been plagued by an abiding uncertainty about the proper application of the step-transaction doctrine. It is no exaggeration to say that "the courts' applications of the step transaction doctrine have been enigmatic," resulting in varying tests that "'are notably abstruse – even for such an abstruse field as tax law.'" *Securities Indus. Ins. Co.* v. *United States*, 702 F.2d 1234, 1244 (CA5 1983) (quoting *Redding* v. *Commissioner*, 630 F.2d 1169, 1175 (CA7 1980)). The confusion is not surprising – the doctrine seeks to accommodate two vital principles of tax law that seemingly point in opposite directions: (i) that a taxpayer may structure its transactions in a form calculated to minimize or avoid its tax liability; and (ii) that the substance, not the form, of a transaction is controlling for tax purposes. The first principle underlies all tax planning; the second underlies the government's efforts to maximize tax revenue.

This petition squarely presents the question that lies at the heart of the courts of appeals' division over the step-transaction doctrine, particularly with regard to those large commercially driven corporate financing arrangements that have the greatest implications for business planning and the public fisc: in what circumstances may taxpayers utilize bona fide intermediaries to minimize the tax burden of otherwise legitimate transactions? The D.C. Circuit held that the role of the intermediary in this case, Del BV, had to be disregarded because it was included in the transaction only for tax purposes. Other circuits squarely reject that rule. The upshot is that "[t]he law is unclear as to the relationship between the step transaction doctrine and the business purpose requirement." *Associated Wholesale Grocers* v. *United States*, 927 F.2d 1517, 1526 (CA10 1991).

Specifically, certiorari should be granted because the decision below conflicts with decisions of the Seventh and Eleventh Circuits. Both of those courts rely on the holding of *Gregory* v. *Helvering*, *supra*, that, because taxpayers are entitled to engage in tax planning, every genuine step in a transaction is entitled to recognition notwithstanding the fact that it was included only to further the taxpayer's intent to eliminate its U.S. tax liability. Thus, in *Northern Indiana Public Service Co.* v. *Commissioner* ("*NIPSCO*") – a decision that involved a transaction very similar to this one in which a Dutch intermediary was included only to trigger the U.S.-Netherlands tax treaty and thereby avoid the thirty-percent tax on interest payments – the Seventh Circuit held that the intermediary's involvement could *not* be disregarded so long as the intermediary was not "merely transitory, engaging in absolutely no business activity for a profit," *i.e.*, it was not "a 'mere skeleton.'" 115 F.3d 506, 513 (1997). Similarly, in *United Parcel Service* v. *Commissioner* ("*UPS*"), the Eleventh Circuit held that an intermediary's involvement in a transaction may not be disregarded so long as the transaction as a whole has real economic effects and "figures in a bona fide, profit-seeking business." 254 F.3d 1014, 1019 (2001). Under these precedents, the Seventh and Eleventh Circuits would hold on the facts of this case that the interest payments made by Taxpayer to Del BV must be recognized as such for tax purposes because they figured in a bona fide loan and because Del BV was an ongoing entity, not a "mere skeleton."

A. The taxpayer in *NIPSCO* sought to borrow funds from a group of foreign lenders collectively known as the "Eurobond market." Solely to avoid the U.S. tax on interest payments to foreign entities, the taxpayer included a Netherlands Antilles intermediary in the transaction. 115 F.3d at 511. Specifically, it created a Netherlands Antilles subsidiary to issue the notes on the Eurobond market and to lend the resulting funds to the taxpayer. The taxpayer guaranteed payment on the notes. Each payment by the

taxpayer to the subsidiary was matched by a corresponding payment, out of the same funds, to the noteholders. The taxpayer paid the subsidiary a one-percent higher rate than was due on the notes (known as an interest rate "spread"), and the subsidiary invested the spread to generate additional funds. After paying off the notes, the taxpayer liquidated the subsidiary, recouping the remaining funds in its accounts. See *id.* at 508.

The Commissioner maintained that the subsidiary's involvement should be disregarded and assessed a deficiency of approximately $15 million. The Tax Court, however, held that the intermediary's involvement in the transaction "was recognizable for tax purposes," and the Seventh Circuit affirmed. 115 F.3d at 509. The Tax Court and the Seventh Circuit rejected the very argument by the Commissioner that the D.C. Circuit accepted in this case – namely, that the subsidiary's involvement should be disregarded because it was included solely to secure the benefit of the U.S.-Netherlands tax treaty and thereby avoid the tax on interest income.

The Seventh Circuit explained that the Commissioner's position would contravene the holding of *Gregory* v. *Helvering*, *supra*, that every "taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes." 115 F.3d at 511. In *Gregory*, this Court firmly settled the right of a taxpayer to engage in tax planning – *i.e.*, to structure transactions in the manner most beneficial to it under the tax laws. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." 293 U.S. at 469. *Gregory* also established the corollary principle that a step in a transaction is entitled to recognition notwithstanding the taxpayer's intent to avoid taxes. "[T]he question for determination is whether what was done, *apart from the tax motive*, was the thing which the statute intended." *Id.* (emphasis added). See also *id.* ("Putting aside,

then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find?"); cf. *United States* v. *Carlton*, 512 U.S. 26, 35-36 (1994) (O'Connor, J., concurring in the judgment) (quoting, and noting the "characteristic acerbity" of, Judge Learned Hand's opinion for the Second Circuit in *Gregory*, subsequently affirmed by this Court) ("'[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.'").

The Seventh Circuit also relied on *Moline Properties* v. *Commissioner*, 319 U.S. 436 (1943), which holds that a corporation and the form of its transactions must be respected for tax purposes so long as it engages in bona fide, economically based activities. Whatever a corporation's purpose, "so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." 319 U.S. at 438-39.

Based on *Gregory* and *Moline Properties*, the Seventh Circuit in *NIPSCO* flatly rejected the Commissioner's reliance on the taxpayer's purpose to avoid paying tax. The court held instead that "so long as a foreign subsidiary conducts substantive business activity–even minimal activity–the subsidiary will not be disregarded for federal tax purposes, notwithstanding the fact that the subsidiary was created with a view to reducing taxes." 115 F.3d at 511. Put another way, the Seventh Circuit adopted the "principle that a corporation and the form of its transactions are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." *Id.* at 512. See also *Falkoff* v. *Commissioner*, 604 F.2d 1045, 1048, 1050 (CA7 1979) (when

"transaction, viewed as a whole, did have economic substance," "taxpayer's purpose to avoid taxation alone [does] not provide a sufficient basis for reshaping the transaction to change its tax repercussions"). Under this standard, the intermediary's role in *NIPSCO* was entitled to recognition: "The record demonstrates that [the intermediary] 'was managed as a viable concern, and not as simply a lifeless facade.' [It] conducted recognizable business activity–concededly minimal activity, but business activity nonetheless." 115 F.3d at 513.

In direct conflict with the D.C. Circuit's holding in this case, the Seventh Circuit would hold that Taxpayer's interest payments to Del BV are entitled to recognition as such for tax purposes. Although critical of Del BV's operations, the Tax Court explicitly found that Del BV engaged in "minimal business activity." Pet. App. 18a. See also *id.* 22a-23a (same). The Seventh Circuit applies precisely that standard in deciding whether to recognize an intermediary's involvement in a transaction. *NIPSCO* holds that an intermediary's role must be respected for tax purposes whenever the intermediary is not a "lifeless facade," *i.e.*, when it "conducts substantive business activity–*even minimal activity*." 115 F.3d at 511 (emphasis added). Indeed, the Seventh Circuit manifestly would find, *a fortiori*, that Del BV's operations and participation in the financing transaction at issue are entitled to recognition because it is undisputed that Del BV (like the intermediary in *NIPSCO*) engaged in minimal business activity and (unlike the intermediary in *NIPSCO*) was created for reasons independent of the loan in this case, engaged in additional business transactions that were unrelated to the loan, and was not controlled in any respect by Taxpayer. See *supra* at 6.

Nor can the transactions in *NIPSCO* and this case fairly be distinguished – except in respects that make it abundantly clear that the Seventh Circuit would recognize Del BV's role. The transactions in both cases were designed exclusively to secure overseas financing for bona fide commercial purposes.

In both cases the transactions used an intermediary in order to invoke the interest withholding tax exemption of the U.S.-Netherlands tax treaty and thereby avoid piling the U.S. tax on interest payments to foreign entities on top of the tax owed abroad on those same payments. Both taxpayers provided security to the original lender. Both taxpayers also paid a higher interest rate than was due on the original loans, although Petitioner's argument is stronger because it paid one-and-a-half percent more (versus one percent in *NIPSCO*), and the intermediary in this case received the funds as a capital contribution rather than as a loan and therefore did not formally owe any other party any interest *at all*. Finally, the intermediaries in both cases were affiliated with the taxpayers, although Petitioner's argument is once again stronger because it had no control over Del BV's operations. In *NIPSCO*, by contrast, the intermediary was a subsidiary of the taxpayer.

There is no basis for the D.C. Circuit's claim in this case that *NIPSCO* can be distinguished on the ground that the intermediary in *NIPSCO* "had a legitimate business purpose other than U.S. tax avoidance": to "obtain funds on the Eurobond market" and to "receive[] a profit from its transactions with the U.S. taxpayer." Pet. App. 11a-12a. The Taxpayer in *NIPSCO* created the intermediary and utilized it in the transaction solely to avoid taxes. As the Tax Court explained in *NIPSCO*, "The *whole* business purpose of [the intermediary] was to facilitate [NIPSCO's] borrowing $70 million." *Northern Ind. Pub. Serv. Co.* v. *Commissioner*, 105 T.C. 341, 352 n.9 (1995) (emphasis added). See also *id.* at 351-52 ("[intermediary's] *only* business purpose was to borrow money in Europe and lend money to [NIPSCO]" (emphasis added)). The Seventh Circuit, in turn, recognized that it was "*undisputed* that Taxpayer structured its transactions with [the intermediary] in order to obtain a tax benefit–specifically, to avoid the thirty-percent withholding tax," but rejected the Commissioner's reliance on "the legal

significance of Taxpayer's tax-avoidance motive." *Id.* at 511 (emphasis added).[5]

Although the D.C. Circuit was correct to state that the intermediary in *NIPSCO* obtained funds from the Eurobond market (see Pet. App. 12a), that fact just reflects the U.S. parent corporation's tax-avoidance motive. The parent had the power and ability to issue the notes itself, but it avoided U.S. tax only by structuring the transaction to have the subsidiary nominally issue the notes while serving as a conduit for the parent's interest payments. Similarly, in this case, Del BV secured funds that originated with a Canadian bank's loan to a related Canadian entity that, according to the D.C. Circuit, Taxpayer could have obtained directly from the related Canadian entity. By including Del BV in the transaction, Taxpayer sought to protect its interest payments from U.S. tax.

Nor, contrary to the D.C. Circuit's opinion (Pet. App. 12a), was there any "profit motive" for involving the intermediary in the transaction in *NIPSCO*. As just discussed, the Tax Court there found, and the Seventh Circuit subsequently accepted, that the only purpose for using the intermediary was tax avoidance. Although the intermediary in *NIPSCO* earned a "profit" in the sense that it invested the interest-rate spread, that was in no sense the "motive" for the transaction, and any such "profit" was returned to the taxpayer. See 115 F.3d at 508 (taxpayer paid off notes and liquidated intermediary); Commr's T.C. Reply Br. in *NIPSCO* at 28 n.1 (one-percent interest spread utilized not for profit

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[5] For the same reason, the D.C. Circuit was wrong to assert (Pet. App. 12a) that *NIPSCO* can be distinguished on the ground that the Tax Court in that case ruled for the taxpayer and the Seventh Circuit merely held "that the lower court did not clearly err in finding that the transactions had a legitimate business purpose other than U.S. tax avoidance." As just discussed, the Tax Court found precisely the opposite – *i.e.*, it found that the only purpose for involving the intermediary was tax avoidance – and the Seventh Circuit accepted that finding in affirming.

motive but instead to conform to Netherlands Antilles tax law).[6]

In any event, the Seventh Circuit found the issue of "profit" relevant in *NIPSCO* only to the distinct question whether the transaction was entitled to recognition under the terms of the U.S.-Netherlands tax treaty. See 115 F.3d at 513 (contrasting *Aiken Indus.* v. *Commissioner*, 56 T.C. 925 (1971)). The Tax Court and D.C. Circuit in this case did not reach that issue because they held that the step-transaction doctrine precluded recognizing Del BV's involvement at all. This Court accordingly would likely leave the treaty question to be resolved on remand in the first instance.[7]

B. Certiorari is warranted for the further reason that the D.C. Circuit's decision in this case conflicts with the Eleventh

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[6] Furthermore, any such "profit motive" would not distinguish *NIPSCO* from this case. The record shows that Del BV made a substantial profit over the life of the loan (see C.A. J.A. 80, 104, 128, 155, Stip. Exhs. 10-P to 13-P), and even the Commissioner effectively conceded in the court of appeals that profit was earned (Resp. C.A. Br. 32). Although Del BV's profit was smaller in dollar terms than in *NIPSCO* because the loan in this case was one-seventh as large, it would be perverse to hold – and no statute or regulation suggests – that a transaction will receive tax recognition only if it avoids a truly massive amount in taxes. In addition, the Commissioner's contention that it was "far from clear" that Del BV retained or invested the spread on the interest it received from Taxpayer (*id.* at 33) is irrelevant. The Tax Court separately concluded, and indeed the parties stipulated, that Del BV engaged in other business activities. See *supra* at 6.

[7] To the extent it is relevant, the Seventh Circuit clearly would have held on these facts that Taxpayer was entitled to the benefit of the U.S.-Netherlands tax treaty. The Seventh Circuit in *NIPSCO* adopted the Tax Court's holding in *Aiken Industries* v. *Commissioner*, 56 T.C. 925 (1971), that a tax treaty does not apply to a transaction in which the nominal recipient of the interest payments "lack[s] dominion and control over the interest payments." 115 F.3d at 513. The same factors that led the Seventh Circuit to hold that the intermediary had "dominion and control" over the funds in *NIPSCO* (see *id.* at 513-14) are present here. Taxpayer's interest payments decreased its economic resources, Taxpayer had no control over Del BV's operations, and the funds originated from a third-party lender (the Canadian bank). Del BV also received interest at a higher rate than was due on the original Canadian loan.

Circuit's decision in *United Parcel Service* v. *Commissioner*, 254 F.3d 1014 (2001). The *UPS* case involved the taxation of "excess-value charges" that the taxpayer (UPS) collected from its customers for additional insurance on shipments. Initially, UPS recorded the charges as ordinary income, deducting the costs of claims it paid. But later, and with the obvious, exclusive purpose to "avoid paying taxes," UPS restructured the program by introducing an intermediary. 254 F.3d at 1016.

Specifically, UPS entered into an insurance contract with a third-party insurer that, in turn, entered into a reinsurance contract with an affiliate that UPS created for the benefit of UPS shareholders. Under this arrangement, UPS accepted charges from customers and paid claims just as it had before, but it then transferred the remaining profits to the intermediary, which simply passed the profits on to the UPS affiliate after deducting a fixed amount. Under the reinsurance agreement, the intermediary insurer accepted no real risks. All the profits went to the UPS shareholders as the owners of the affiliate.

The Tax Court agreed with the Commissioner that the intermediary's involvement should be disregarded. The court reasoned that "the plan had no defensible business purpose" and the "sole motivation [for utilizing the intermediary] was tax avoidance." 254 F.3d at 1017. In other words, the insurer "was no more than a 'front' in what was a transfer of revenue from UPS to [the affiliate]." *Id.* at 1019. The court held that the taxpayer was liable for approximately $67 million in deficiencies, *plus* penalties and additions.

The Eleventh Circuit reversed, holding that, notwithstanding that the intermediary was included in the transaction *solely* to avoid taxes, its role must be respected so long as the transaction as a whole (i) has "economic effects other than the creation of tax benefits," and (ii) has some "business purpose" other than "tax avoidance." 254 F.3d at 1018. Regarding the former, the court of appeals held that

"[t]he kind of 'economic effects' required to entitle a transaction to respect in taxation include the creation of genuine obligations enforceable by an unrelated party." *Id.* That test was satisfied because UPS had a contract with the intermediary insurer and, in any event, the affiliate was "an independently taxable entity that [was] not under UPS's control." *Id.* at 1019. It was sufficient that "UPS really did lose the stream of income it had earlier reaped from [insurance] charges." *Id.* See also *id.* ("UPS genuinely could not apply that money to any use other than paying a premium to [the insurer]; the money could not be used for other purposes, such as capital improvement, salaries, dividends, or investment.").

Regarding the second element of its test, the Eleventh Circuit rejected "the tax court's narrow notion of 'business purpose'" in favor of an inquiry into whether the transaction "figures in a bona fide, profit-seeking business." 254 F.3d at 1019. See also *id.* (adopting "broader notion of business purpose"). Like the Seventh Circuit in *NIPSCO*, the Eleventh Circuit in *UPS* relied on *Gregory* v. *Helvering*, *supra*, reasoning that a broad interpretation of a sufficient "business purpose" for tax recognition was "a necessary corollary to the venerable axiom that tax-planning is permissible." *Id.* Thus,

> The Code treats lots of categories of economically similar behavior differently. For instance, two ways to infuse capital into a corporation, borrowing and sale of equity, have different tax consequences; interest is usually deductible and distributions to equityholders are not. There may be no tax-independent reason for a taxpayer to choose between those different ways of financing the business, but it does not mean that the taxpayer lacks a "business purpose." To conclude otherwise would prohibit tax-planning.

Id. Applying that standard, the Eleventh Circuit held that the intermediary's involvement could not be disregarded because

it was part of "a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure." *Id.* at 1020. The court subsequently denied the Commissioner's petition for rehearing *en banc*.

In direct conflict with the D.C. Circuit, the Eleventh Circuit would hold in this case that Taxpayer's interest payments to Del BV must be respected for tax purposes. The D.C. Circuit rested its contrary decision on the fact that Taxpayer's payments to Del BV "only served to avoid U.S. taxes," holding that an intermediary's involvement in a transaction will be "disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included [a] step for no other purpose than to avoid U.S. taxes." Pet. App. 6a, 7a. The Eleventh Circuit rejected precisely that reasoning in *UPS*. The Eleventh Circuit would find it sufficient in this case that Taxpayer received a bona fide loan on which Taxpayer made bona fide interest payments (whether the loan was regarded as having been received from the Canadian bank, the Canadian affiliate, or Del BV) and that the loan was made in furtherance of Taxpayer's legitimate business. At bottom, the Eleventh Circuit would hold in this case that the structure of the loan was entitled to respect for tax purposes under the "venerable axiom that tax-planning is permissible." 254 F.3d at 1019.[8]

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[8] The D.C. Circuit's reliance (Pet. App. 6a) on *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609 (1938), to reach a contrary result – *i.e.*, to hold that Del BV's role should not be recognized – was misplaced. *Minnesota Tea* held that a corporation's use of its shareholders as a conduit to pay its debts did not qualify as a tax-free "distribution" to the shareholders. That result makes perfect sense because the shareholders played no actual role in the transaction, and Congress could not have contemplated that such an artifice would be treated as a "distribution." But even on the most expansive reading of *Minnesota Tea*'s holding, that decision does not apply to transactions in which the intermediary is a bona fide entity that engages in bona fide transactions. See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945) (citing *Minnesota Tea* for the proposition that "the true nature of a transaction" may not "be disguised by *mere formalisms*, which exist solely to alter tax liabilities" (emphasis added)). Compare *United States* v. *Cumberland Pub.*

C. Finally, it bears noting that the step-transaction doctrine controls the taxation of all of Taxpayer's interest payments, including those that Taxpayer made directly to the Canadian affiliate at Del BV's direction. That was the view of the Tax Court, which treated the payments to the Canadian affiliate merely as evidencing a "link" between the Canadian loan and the loan from Del BV. Pet. App. 23a. The D.C. Circuit, by contrast, for the second half of the tax period, looked exclusively to the form of the payments to hold that (because they were never formally received by Del BV) they were not encompassed by the U.S.-Netherlands tax treaty. *Id.* 7a.

The court of appeals' decision conflicts with the long-settled "assignment of income" doctrine, which holds that "income is taxed to the party who earns it and that liability may not be avoided through an anticipatory assignment of that income," and which reflects "'the first principle of income taxation: that income must be taxed to him who earns it.'" *United States* v. *Basye*, 410 U.S. 441, 447, 449 (1973) (quoting *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-40 (1949)). As this Court explained in *Helvering* v. *Horst*, 311 U.S. 112, 118 (1940): "The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it." See also *United States* v. *Byrum*, 408 U.S. 125, 139 n.14 (1972) (under assignment of income doctrine, "the issue is who has the power over income").

The application of the assignment of income doctrine to this case is straightforward. If Del BV's ownership of Taxpayer's interest payments is entitled to recognition under

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Serv. Co., 338 U.S. 451 (1950) (limiting *Court Holding Co.*). Most recently, this Court has cited *Minnesota Tea* simply for the proposition that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction." *Commissioner* v. *Clark*, 489 U.S. 726, 738 (1989).

the step-transaction doctrine, it makes no difference that, for a time, Taxpayer sent those payments to a Canadian affiliate at Del BV's direction. Just as Del BV could not avoid taxation by assigning the interest income to a Canadian entity, so too the Commissioner cannot, on the basis of the assignment, ignore Del BV's beneficial ownership of the interest. See, *e.g.*, *Basye*, 410 U.S. at 447, 449 (partnership responsible for tax on retirement fund payments, notwithstanding that "payments were never actually received by the partnership but were contributed directly to [a] trust" at the partnership's direction); *Horst*, 311 U.S. at 117-18 (owner of bonds liable for tax on interest income notwithstanding assignment of interest coupons). Indeed, for the government to rely only on the form of Taxpayer's payments to the Canadian affiliate rather than their substance would flatly contradict the Commissioner's position under the step-transaction doctrine that it is the *substance* of the transaction, not the *form* of the loan from Del BV, that controls.

II. The Question Presented Has Surpassing Importance.

Certiorari is especially appropriate because this case presents a seminal question for purposes of private tax planning and the administration of the tax laws. Virtually every transaction – whether domestic or international, individual or corporate – has the potential to be profoundly affected by the still-uncertain contours of the step-transaction doctrine. The lower courts have thus long recognized that "'whether to accord the separate steps of a complex transaction independent significance, or to treat them as related steps in a unified transaction, is a recurring problem in the field of tax law.'" *True* v. *United States*, 190 F.3d 1165, 1174 (CA10 1999) (quoting *King Enters.* v. *United States*, 418 F.2d 511, 516 (Ct. Cl. 1969)). See also *Brown* v. *United States*, 868 F.2d 859, 862 (CA6 1989) (same).

The grave implications of the decision below for private tax planning are difficult to overstate. As both the *NIPSCO* and *UPS* decisions illustrate, the basic model for the

transaction in this case – in which an intermediary was utilized as a participant for tax purposes – is a commonplace practice in modern corporate finance. More generally, businesses routinely enter into bona fide, commercially motivated transactions that are implemented in dozens of steps, several of which may be designed to take advantage of the tax laws. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.05[2][d] (6th ed. 1999) ("A business transaction often has no clearly defined beginning or end, but it may be necessary in practice to divide it, usually chronologically, into segments for tax purposes."). As the Eleventh Circuit recognized, to prohibit such practices "would prohibit tax-planning." *UPS*, 254 F.3d at 1019. The D.C. Circuit's holding blithely calls such basic business practices into question and threatens the viability for tax purposes of numerous transactions that have already been consummated or that are currently being planned. It will almost *always* be true that, in a sophisticated transaction, a business "could have achieved its objective more directly" but included a step "for no other purpose" than to avoid a tax. Pet. App. 6a. Until now, that was an accepted means of doing business in the United States and was never thought automatically to strip a transaction of tax recognition. The fact that the question presented is particularly likely to arise in large corporate transactions (which are often undertaken by sophisticated actors with multiple affiliates or the capability to create subsidiaries) in which large sums of money are involved only highlights the importance of this case both to taxpayers and to the public fisc. Cf. *supra* at 10, 16 (describing multi-million-dollar deficiencies asserted by the Commissioner in *NIPSCO* and *UPS*).

The D.C. Circuit's exclusive focus on the subjective "purpose" animating a step in a transaction creates uncertainty in tax planning for yet another reason. A taxpayer cannot know *ex ante* whether the Commissioner and a reviewing court will later accept that a particular step in a

transaction is entitled to recognition because it was motivated principally, but not exclusively, by a desire to avoid U.S. tax liability. In this case, for example, the D.C. Circuit found insufficient proof that Taxpayer intended as well to secure Canadian tax savings. See Pet. App. 8a-10a. Taxpayers may therefore be deterred from engaging in entirely lawful transactions by the substantial penalties and additions that are imposed for the failure to pay tax. Cf. RICHARD A. WESTIN, FEDERAL TAX PLANNING ¶ 2.35 (2d ed. 1995) (cautioning with respect to step-transaction doctrine that "ambiguous judicial doctrines well known to tax practitioners throw uncertain nets over activities not reached by the particular corrective statutory rules"). By contrast, the holdings of the Seventh and Eleventh Circuits, which look not to the taxpayer's intent but rather to objective indicia of whether the transaction and the intermediary were bona fide, provide far greater certainty in tax planning.

The question presented has even greater significance because, although the holding below applies equally to domestic and international transactions, the D.C. Circuit's decision threatens the treaty obligations of the United States. Once duly ratified by the Senate, tax treaties are the supreme law of the land. U.S. Const., Art. VI, § 2, cl. 2. Indeed, the Internal Revenue Code specifies that its provisions are superceded by treaty obligations. See 26 U.S.C. § 894. To the extent that the U.S.-Netherlands treaty conflicts with the common law step-transaction doctrine, the treaty controls because it was adopted later in time. See *Cook* v. *United States*, 288 U.S. 102, 118-19 (1933). The D.C. Circuit, however, did not even consider whether the transaction in this case fell within the letter or intent of the treaty, which it does. See *supra* at 15 n.7. The court of appeals instead regarded the step-transaction doctrine as a brooding omnipresence bent on eliminating tax avoidance no matter what a treaty may provide to the contrary. The result in this case is that, directly contrary to the treaty's intent, taxpayers are subject to double

taxation because Del BV duly reported the interest income it received from Taxpayer on its Dutch tax returns.

The D.C. Circuit's single-minded application of federal common law tax doctrines is in considerable tension with the status of treaties in our legal framework and carries the potential to abrogate our international obligations. That concern is heightened here by the fact that the D.C. Circuit's decision will have broad international application because that court has jurisdiction over most tax appeals filed by corporations that have their principal place of business overseas. See 26 U.S.C. § 7482(b)(1). This case accordingly directly implicates the "large controversy * * * within the international community as to whether general domestic anti-avoidance rules are applicable in the context of a treaty." Simone M. Huag, *The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis*, 29 VAND. J. TRANSNAT'L L. 191, 231-32 (1996). See also Tracy A. Kaye, *European Tax Harmonization and the Implications for U.S. Tax Policy*, 19 B.C. INT'L & COMP. L. REV. 109, 169 (1996) (noting European concerns over U.S. tax treaty overrides).[9]

The substantial importance of the question presented should heighten this Court's sensitivity to the clear conflict between the D.C. Circuit's holding that a taxpayer's intent to avoid taxes will trigger application of the step-transaction doctrine and the contrary holdings of the Seventh and Eleventh Circuits. As the Commissioner often argues in

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[9] For example, most modern tax treaties directly address tax-avoidance schemes through "Limitations on Benefits Clauses" that spell out the circumstances in which a party's relationship to the treaty state is insufficient to receive the treaty's benefits. See generally PETER H. BLESSING & CAROL DUNAHOO, INCOME TAX TREATIES OF THE UNITED STATES § 22.01[1] (1999); MICHAEL J. MCINTYRE, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 4-38 to -39 (2d ed. 2000); PHILIP F. POSTLEWAITE, INTERNATIONAL TAXATION: CORPORATE AND INDIVIDUAL 13-17 (3d ed. 2000). The D.C. Circuit's approach, however, disallows many transactions that would qualify under such Clauses.

seeking review of less important disagreements in the courts of appeals, this Court has long recognized that the Nation's tax laws are to be interpreted and applied to "ensure as far as possible that similarly situated taxpayers pay the same tax." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 544 (1978), *quoted in*, *e.g.*, Pet. for Cert., No. 00-1831, *United States* v. *Craft* at 9, *cert. granted*, 70 U.S.L.W. 3232 (Sept. 25, 2001). It is simply untenable that the resolution of not only an important question of tax law but also of the application of an international treaty should turn on which circuit happens to have jurisdiction over the taxpayer's appeal.[10]

Because the conflict in the circuits presented by this case deprives the tax laws of badly needed certitude on a fundamental question of tax law, certiorari should be granted.

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[10] It is not surprising that many of this Court's opinions addressing related issues reflect that certiorari was granted to resolve one-to-one circuit conflicts. *E.g.*, *Commissioner* v. *Clark*, 489 U.S. 726 (1989); *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978); *Moline Properties* v. *Commissioner*, 319 U.S. 436 (1943); *Griffiths* v. *Commissioner*, 308 U.S. 355 (1939).

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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October 26, 2001

APPENDIX

DEL COMMERCIAL PROPERTIES, INC.,
APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE,
APPELLEE

No. 00-1313

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

March 13, 2001, Argued
June 8, 2001, Decided

Before: SENTELLE, TATEL and GARLAND, Circuit Judges. Opinion for the Court filed by Circuit Judge SENTELLE.

SENTELLE, *Circuit Judge*: On July 18, 1990, Delcom Financial Ltd., a Canadian corporation, took out an $ 18 million loan from the Royal Bank of Canada. This loan initiated a series of transactions over the next twenty-four hours, involving five companies organized in Canada, the Cayman Islands, the Netherlands Antilles, the Netherlands, and the United States--all of which were related to each other and to Delcom Financial. The final transaction was a $ 14 million loan from Del Investments Netherlands B.V. ("Del BV"), a Dutch corporation, to Del Commercial Properties, Inc., an American corporation. Over the next year and a half, Del Commercial repaid Del BV, who then transferred the payments to Delcom Financial (or another related corporation), who in turn paid off the Royal Bank loan. In July 1992, Del Commercial began repaying Delcom Financial directly. Throughout this entire period, however, Del BV

reported Del Commercial's interest payments on its Dutch tax returns.

In 1997, the Commissioner of Internal Revenue in the United States ("Commissioner") informed Del Commercial that it owed taxes and additions based on the interest payments it made between 1990 and 1993. *See* 26 U.S.C. § § 881, 1442, 6651(a)(1), 6656. Del Commercial petitioned the Tax Court, claiming that in light of a treaty between the United States and the Netherlands the corporation owed no tax on interest payments made to Del BV. The Tax Court ruled against Del Commercial, finding that the series of transactions between the related companies was a sham designed solely to avoid U.S. taxes. *See Del Commercial Props., Inc. v. Commissioner*, T.C. Memo 1999-411, No. 1887-98, slip op. at 11 (Dec. 20, 1999). Based on this ruling, the Tax Court ordered Del Commercial to pay $ 1,194,573 in taxes and additions. Del Commercial now appeals from the Tax Court's decision. For the reasons set forth below, we affirm.

I. BACKGROUND

Del Commercial Properties, Inc. ("appellant") is an Illinois corporation whose principal place of business is in Ontario, Canada. It is a fourth-tier subsidiary of an affiliated group of corporations ("the Affiliated Group") whose common parent is DL Shekels Holdings Ltd. Delcom Financial, Ltd. is a second-tier subsidiary in the Affiliated Group. Delcom Financial is a Canadian corporation that owns 100% of the outstanding stock of Delcom Holdings, Ltd., another Canadian corporation. In turn, Delcom Holdings owns 100% of Delcom Cayman, Ltd. (a corporation organized in the Cayman Islands), which owns 100% of the outstanding stock of Delcom Antilles, N.V. (a corporation organized in the Netherlands Antilles). Delcom Antilles owns 100% of the outstanding stock of Del Investments Netherlands B.V. ("Del BV"), a corporation organized in the Netherlands.

From 1990 through 1993, appellant's principal business was leasing industrial real estate it owned in the United States. In 1990, when appellant needed funding to refinance and improve some of its American properties, one of DL Shekels's first-tier subsidiaries, Tridel Corporation, arranged the following financing scheme: On July 18, 1990, the Royal Bank of Canada loaned $ 18 million (in U.S. dollars) to Delcom Financial. That same day, Delcom Financial made two unsecured interest-bearing loans to Delcom Holdings. One of those loans (the one directly relevant to this case) was for $ 14 million. Delcom Holdings then contributed "about $ 14 million to Delcom Cayman for common shares of stock." Stipulation of Facts at 5, *Del Commercial Props., Inc. v. Commissioner*, T.C. Memo 1999-411, 1999 Tax Ct. Memo LEXIS 468, 78 T.C.M. (CCH) 1183 (Oct. 22, 1998). On the same day, "Delcom Cayman contributed about $ 14 million to Delcom Antilles and received common shares of stock in that entitiy. Later on that same date, Delcom Antilles contributed about $ 14 million to Del BV and received common stock in that entity." *Id.* at 5-6.

The following day, July 19, appellant borrowed $ 14 million from Del BV. That same day, appellant "guaranteed repayment of a portion of amounts owed by Delcom Financial to Royal Bank" and authorized Royal Bank to place a mortgage on its real property in the U.S. *Id.* at 7. Appellant also agreed to provide Royal Bank with "annual financial statements, to insure its real property, to assign the insurance policies to Royal Bank, to defer paying dividends to shareholders, and to use the proceeds from any sales of real property to make payments on the $ 14 million Royal Bank loan." Brief for the Appellee at 6.

On January 1, 1991, appellant began repaying Del BV. Del BV transferred these payments "either to Delcom Holdings or Delcom Financial. The funds were used to pay principal and interest owed on the $ 14 million Royal Bank loan." *Del Commercial Props.*, T.C. Memo 1999-411, slip op. at 7. Beginning in July 1992, however, appellant began

making its loan payments directly to Delcom Financial, "and Delcom Financial then forwarded funds to Royal Bank in payment on the Royal Bank loan." *Id.* Throughout this time, Del BV reported the interest paid by appellant as income on its Netherlands tax returns. Meanwhile, appellant did not file United States withholding tax returns or deposit withholding taxes on any payments related to the loan.

On October 30, 1997, the Commissioner provided appellant with a Notice of Deficiency stating that it owed taxes and additions based on the interest payments made between 1990 and 1993. *See* 26 U.S.C. §§ 881, 1442, 6651(a)(1), 6656. Appellant petitioned the Tax Court to determine the correct amount of taxes and additions, contending that under a treaty between the United States and the Netherlands, no tax is owed to the United States on interest payments made by an American corporation to a Dutch corporation. The Tax Court held that the series of loans and stock contributions that began with Delcom Financial and ended with appellant "reflect a step transaction created simply to bypass U.S. withholding tax." *Del Commercial Props.*, T.C.M. 1999-411, slip op. at 11. Because the appellant had not "presented any credible argument" that its failure to file a tax return or deposit withholding taxes was "attributable to reasonable cause," the Tax Court concluded that appellant owed penalties in addition to the withholding taxes. *Id.* at 13. Accordingly, the Tax Court ordered appellant to pay $ 1,194,573 in taxes and additions.

Appellant appeals from that decision.

II. ANALYSIS

We review Tax Court decisions "in the same manner and to the same extent" as a decision issued by a district court. *26 U.S.C. § 7482.* That is, questions of law are reviewed *de novo*, while questions of fact are reviewed for clear error. *See ASA Investerings P'ship v. Commissioner*, 340 U.S. App. D.C. 55, 201 F.3d 505, 511 (D.C. Cir.), *cert. denied*, 148 L. Ed. 2d 117, 121 S. Ct. 171 (2000). As we recently noted, "in

tax cases mixed questions of law and fact are to be treated like questions of fact." *Id.*

Appellant challenges the Tax Court's decision on two grounds. First, it argues that the Tax Court erred in concluding that it was responsible for withholding United States taxes on the interest payments it made to Del BV. According to appellant, the financing scheme was not designed solely to avoid U.S. taxes. Rather, the scheme sought to allow the Affiliated Group to achieve substantial Canadian tax savings, a permissible business purpose under American tax law. Second, appellant contends that even if it should have withheld U.S. taxes on the interest payments, the Tax Court erred by imposing a penalty for appellant's failure to file withholding tax returns or to deposit the withholding tax. Specifically, appellant suggests that it should not be penalized because its decision not to withhold represented a reasonable difference of opinion with the Commissioner. We address each of these issues in turn.

A. Withholding of Interest Payments

The Internal Revenue Code requires foreign corporations to pay "a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest ... to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States." 26 U.S.C. § 881(a). An American taxpayer who makes such interest payments is required to deduct and withhold the tax owed by the foreign corporation. *See* 26 U.S.C. §§ 1441, 1442. If the American taxpayer fails to deduct and withhold the tax, he is personally liable for the tax due. *See* 26 U.S.C. § 1461.

Pursuant to the United States-Netherlands Tax Treaty, interest payments made by American taxpayers to Netherlands corporations are exempt from taxes in the United States. *See* Convention With Respect to Taxes on Income, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855 (*extended to* the Netherlands Antilles by

Protocol June 15, 1955, 6 U.S.T. 3696, T.I.A.S. No. 3366; *amended by* Protocol, Oct. 23, 1963, 15 U.S.T. 1900, T.I.A.S. No. 5565; *modified by* Convention, Dec. 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051). In contrast, under the United States-Canada Tax Treaty, the tax on interest payments "shall not exceed 15 percent of the gross amount of the interest" if the recipient of the payments is "the beneficial owner of such interest." Convention on Taxes on Income and Capital, Sept. 26, 1980, U.S.-Can., Art. XI, T.I.A.S. No. 11087.

Under the step-transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes. *See Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613, 82 L. Ed. 474, 58 S. Ct. 393 (1938). In step-transaction cases, "the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive." *ASA Investerings*, 201 F.3d at 512. As we explained last year, "the absence of a nontax business purpose is fatal." *Id.* Although taxpayers "are entitled to structure their transactions in such a way as to minimize tax," there must be a purpose for the "business activity ... other than tax avoidance" and that purpose cannot be a "facade." *Id.* at 513; *see also N. Ind. Pub. Serv. Co. v. Commissioner ("NIPSCO")*, 115 F.3d 506, 512 (7th Cir. 1997) (stating that the IRS cannot "disregard economic transactions ... which result in actual, non-tax-related changes in economic position").

The Internal Revenue Service--and the courts--will ignore a step in a series of transactions if that step does " 'not *appreciably* affect [the taxpayer's] beneficial interest except to reduce his tax.' " *ASA Investerings*, 201 F.3d at 514 (quoting *Knetsch v. United States*, 364 U.S. 361, 366, 5 L. Ed. 2d 128, 81 S. Ct. 132 (1960) (emphasis added) (quoting *Gilbert v. Commissioner*, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, C.J., dissenting))). In two separate revenue rulings the IRS specifically has held that an American taxpayer cannot avoid U.S. taxes merely by relying on a treaty with a foreign

country. *See* Rev. Rul. 84-153, 1984-2 C.B. 381; Rev. Rul. 84-152, 1984-2 C.B. 383. In other words, if the sole purpose of a transaction with a foreign corporation is to dodge U.S. taxes, the treaty cannot shield the taxpayer from the fatality of the step-transaction doctrine. For the taxpayer to enjoy the treaty's tax benefits, the transaction must have a sufficient business or economic purpose. We accord these rulings *Skidmore* deference--that is, they are "'entitled to respect'" to the extent they "have the 'power to persuade,'" *Christensen v. Harris County*, 529 U.S. 576, 587, 146 L. Ed. 2d 621, 120 S. Ct. 1655 (2000) (quoting *Skidmore v. Swift & Co.*, 323 U.S. 134, 140, 89 L. Ed. 124, 65 S. Ct. 161 (1944))--and we find them persuasive given the plain meaning of 26 U.S.C. § 881 and § 1442, as informed by *Gregory v. Helvering*, 293 U.S. 465, 469, 79 L. Ed. 596, 55 S. Ct. 266 (1935).

From July 1992 through 1993, appellant made its loan payments directly to Delcom Financial. This fact is uncontested. Although Del BV may have recorded interest payments in its ledgers and reported them on its Dutch tax returns, there is no evidence that appellant paid anything to Del BV during this period. The U.S.-Netherlands Tax Treaty does not apply to direct transactions between a U.S. corporation and a Canadian corporation. Accordingly, appellant unquestionably should have withheld taxes on its payments to Delcom Financial beginning in July 1992. The Tax Court plainly did not err in coming to this conclusion.

Likewise, the Tax Court did not clearly err in concluding that the payments from appellant to Del BV were in substance payments made to Delcom Financial and that those payments only served to avoid U.S. taxes. The Tax Court's decision in *Gaw v. Commissioner* is instructive. T.C. Memo 1995-531, Nos. 17906-92, 18268-92 (Nov. 9, 1995), *aff'd*, 111 F.3d 962 (D.C. Cir. 1997) (unpublished table disposition). *Gaw* dealt with a U.S. corporation's interest payments to a Dutch corporation that was a subsidiary of a Hong Kong corporation. The Tax Court held that the payments were subject to U.S. taxes because in substance they were directed

to the Hong Kong corporation. The Tax Court explained that "under the substance over form doctrine, although the form of a transaction may literally comply with the provisions of the [Internal Revenue] Code, that form will not be given effect where it has no business purpose and operates simply as a device to conceal the true character of that transaction." 1995 Tax Ct. Memo LEXIS 530, *124, slip op. at 96. The court reasoned that the taxpayer had not carried his burden of proving that the loans had been structured for any nontax business reason. *See id.* at 114. Consequently, the court treated the loan as if it had been made by the Hong Kong corporation and ruled that the loan was subject to the withholding tax. *See id.* at 141-43.

Similarly, in this case, several facts demonstrate the nexus between the original Royal Bank loan and the loan from Del BV to appellant: (1) the interest rates and repayment schedules of the two loans closely correspond; (2) Royal Bank obtained a guaranty of repayment from appellant and a security interest in appellant's real property; and (3) beginning in the third quarter of 1992, appellant made payments on the loan directly to Delcom Financial at Royal Bank's request. Like the taxpayer in *Gaw*, appellant has failed to carry its burden of proving that Del BV was in substance the real lender for tax purposes. If appellant had received the loan from Royal Bank or Delcom Financial directly, the interest payments would have been taxable under the U.S.- Canada Tax Treaty. Appellant has not shown that Del BV served any role with a "sufficient business or economic purpose to overcome the conduit nature of the transaction." Rev. Rul. 84-153, 1984-2 C.B. at 384.

Appellant contends that the series of transactions between Delcom Financial, Delcom Holdings, Delcom Cayman, Delcom Antilles, Del BV, and appellant was not designed solely to avoid U.S. taxes. Instead, according to appellant, by structuring the transactions as it did, Delcom Financial achieved sizable Canadian tax savings. Appellant claims that Delcom Financial was able to take advantage of a

Canadian tax code provision that allows corporations to deduct interest payments. In other words, Delcom Financial was able to deduct the value of the interest payments it made to Royal Bank as part of the original loan. This deduction was particularly valuable to Delcom Financial (and thus the Affiliated Group) because it received no additional income from which to offset the deduction. In addition, appellant asserts that under Canadian law and a treaty between Canada and the Netherlands, no corporations in the Affiliated Group were required to pay taxes "on amounts that were remitted by Del BV up the chain and ultimately received by [Delcom Financial] as dividends." Brief for Appellant at 7. Ultimately, appellant maintains that the Affiliated Group received substantial Canadian tax benefits relative to the U.S. taxes it avoided.

In Tax Court proceedings, the petitioner maintains the burden of proof. *See* TAX CT. R. 142(a). In this case, appellant absolutely failed to carry its burden; it did not offer any evidence that the Affiliated Group achieved Canadian tax savings. Indeed, appellant did not submit Delcom Financial's Canadian tax returns. Nor did appellant submit any of Delcom Financial's corporate records. Without this evidence, the Tax Court could not have found that Delcom Financial reported or deducted the interest payments and dividends, or otherwise received any Canadian tax benefits.

In addition, appellant did not ask the Tax Court (or this Court) to take judicial notice of the relevant provisions of the Canadian tax code or the Canada-Netherlands tax treaty through which the Affiliated Group claims to have achieved tax savings--it did not even cite the provisions on which it claims to have relied. Given the state of the record, we cannot possibly conclude that appellant carried its burden before the Tax Court or that the Tax Court clearly erred in finding that the transactions served any purpose other than avoiding U.S. taxes.

The only evidence presented to the Tax Court concerning the transactions' supposed Canadian tax benefits is the testimony of William Christie, vice president of corporate planning and taxation at Tridel Corporation (a corporation in the Affiliated Group that provided management and executive services to the related corporations). Christie testified that "I was told" that the "objectives" of the transaction were to secure financing for appellant and "to maximize [the Affiliated Group's] Canadian tax benefits." He also testified that his boss "said that he wanted to finance the [appellant's] operations and to do it in a very tax efficient manner for Canada."

Christie's testimony concerning the objectives of the transactions is hearsay. *See* FED. R. EVID. 801, 802; *see also* 26 U.S.C. § 7453 (providing that Tax Court proceedings shall be conducted "in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia"). As a result, the Tax Court could not--and apparently did not--rely upon it for the truth of the matter asserted.

Likewise, the only evidence appellant offers to establish that the Affiliated Group actually achieved Canadian tax benefits from the transactions is conclusory testimony by Christie. This testimony is inadequate to carry appellant's burden of proof and certainly does not establish that the Tax Court clearly erred.

Appellant contends that the IRS has held that foreign tax avoidance in general is a legitimate business purpose. *See* Rev. Rul. 89-101, 1989-2 C.B. 67. Revenue Ruling 89-101, on which appellant relies, focused on a transaction in which "a first-tier foreign subsidiary corporation distributes the stock of a second-tier foreign subsidiary corporation to the domestic parent corporation to reduce the amount of foreign withholding tax imposed on distributions by the second-tier corporation." *Id.* at 67. The IRS held that the transaction served a corporate business purpose within the meaning of

Treasury Regulation § 1.355-2(b) "because it will benefit the affiliated group of corporations by reducing substantially the amount of foreign withholding tax imposed on distributions from a member of the group." *Id.* at 68.

The Commissioner does not concede that foreign tax avoidance is a legitimate business purpose, and we do not need to address that question here. While perhaps not directly applicable to this case, Treasury Regulation § 1.355-2(b) is instructive. That regulation, which formed the basis for Revenue Ruling 89-101, provides that "reducing non Federal taxes is not a corporate business purpose" if (1) the property distribution reduces "both Federal and non Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction" and (2) "the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes." Treas. Reg. § 1.355-2(b)(2). Based on this regulation and the revenue ruling on which appellant relies, even if foreign tax avoidance is a sufficient business purpose, appellant failed to establish that the Affiliated Group (or any of its members) achieved foreign tax savings greater than its U.S. tax savings--or that it achieved any foreign tax savings for that matter.

Finally, appellant suggests that we should follow the Seventh Circuit's decision in *Northern Indiana Public Service Co. v. Commissioner ("NIPSCO")*, 115 F.3d 506 (7th Cir. 1997), which dealt with the tax treatment of an American corporation's interest payments to a Dutch corporation. We need not comment on whether we agree with *NIPSCO*'s legal analysis or holding; its procedural posture demonstrates why it does not help appellant's cause.

In *NIPSCO*, the taxpayer won in the Tax Court, and the Commissioner appealed. The Seventh Circuit affirmed the Tax Court's judgment, holding that the lower court did not clearly err in finding that the transactions had a legitimate business purpose other than U.S. tax avoidance. *See id.* at 514. The appellate court explained that the Dutch corporation

participated in the transactions because it could obtain funds on the Eurobond market when "prevailing market conditions made the overall cost of borrowing abroad less than the cost of borrowing domestically." *Id.* at 511. Additionally, the Dutch corporation received a profit from its transactions with the U.S. taxpayer. This profit then was reinvested in the Eurobond market. The "profit motive" of the Dutch corporation was sufficient to show that the motive of the transaction was not simply tax avoidance.

Not only are the two cases not factually similar, but the taxpayer's evidence in *NIPSCO* was substantially stronger than the appellant's evidence in this case. Consequently, the *NIPSCO* taxpayer was able to carry its burden of proof in the Tax Court, and on appeal the Commissioner was unable to show that the Tax Court clearly erred. Even more significantly, in the case now before us, the roles of the parties are reversed. The taxpayer lost in the Tax Court, and it has appealed. Accordingly, it is the taxpayer who must establish that the Tax Court's findings were clearly erroneous, which, as we explained above, it cannot do.

B. Additions for Failing to Withhold U.S. Taxes

Section 6651(a)(1) of the Internal Revenue Code imposes a penalty for a person's failure to file a tax return unless the failure is due to "reasonable cause and not due to willful neglect." 26 U.S.C. § 6651(a)(1). Likewise, § 6656(a) imposes a penalty on a person who fails to deposit withholding taxes unless his failure is due to "reasonable cause and not due to willful neglect." *Id.* § 6656(a).

In *United States v. Boyle*, the Supreme Court discussed the meaning of "reasonable cause" and "willful neglect" in § 6651(a)(1). 469 U.S. 241, 245-46, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985). The *Boyle* Court explained that to demonstrate "reasonable cause" a taxpayer must establish "that he exercised ordinary business care and prudence but nevertheless was unable to file the return within the prescribed time." *Id.* at 246 (internal quotation omitted).

"Willful neglect," on the other hand, is demonstrated by the taxpayer's "conscious, intentional failure or reckless indifference." *Id.* at 245. As the Court explained, the taxpayer maintains the "heavy burden" of proving that his failure to file a tax return was due to reasonable cause, not willful neglect. *Id.* The Commissioner suggests that the *Boyle* standard extends to § 6656(a).

Despite the Supreme Court's clear statements in *Boyle*, appellant contends that the proper standard for determining whether it should pay an addition is found in *Spies v. United States*, 317 U.S. 492, 87 L. Ed. 418, 63 S. Ct. 364 (1943), a case in which the taxpayer faced criminal penalties. In *Spies*, the Supreme Court reasoned: "It is not the purpose of the law to penalize frank difference of opinion of innocent errors made despite the exercise of reasonable care. Such errors are corrected by the assessment of the deficiency of tax and its collection with interest for the delay." *Id.* at 496. We echoed this same sentiment many years ago. *See, e.g., Commissioner v. Clarion Oil Co.*, 80 U.S. App. D.C. 41, 148 F.2d 671, 677-78 (D.C. Cir. 1945); *see also Palm Beach Trust Co. v. Commissioner*, 84 U.S. App. D.C. 410, 174 F.2d 527, 527 & n.2 (D.C. Cir. 1949) (per curiam); *Orient Inv. & Fin. Co. v. Commissioner*, 83 U.S. App. D.C. 74, 166 F.2d 601, 604 (D.C. Cir. 1948).

Unfortunately, appellant and the Commissioner do not attempt to reconcile or distinguish *Boyle* and *Spies*. Worse, neither party addresses the other's claim concerning the appropriate standard. Indeed, in their briefs, appellant does not even cite *Boyle*, and the Commissioner does not cite *Spies*.

Although the *Boyle* Court did not address the meaning of the terms "reasonable cause" and "willful neglect" as used in § 6656(a), the same terms used in the same statute for the same purpose presumably have the same meaning. *See Allen v. CSX Transp., Inc.*, 306 U.S. App. D.C. 98, 22 F.3d 1180, 1182 (D.C. Cir. 1994). Because the same terms are used §

6651(a)(1) and § 6656(a) to define the circumstances in which a taxpayer is not required to pay additions, we see no reason why "reasonable cause" and "willful neglect" should not be interpreted consistently.

Notably, the *Boyle* Court did not overrule (or even cite) *Spies*. The *Spies* language cited by appellant, which is dicta, is not necessarily inconsistent with *Boyle*. After noting that the purpose of the tax code is not to "penalize frank difference of opinion," the *Spies* Court pointed out that "if any part of the deficiency is due to negligence or intentional disregard of rules and regulations," the taxpayer is subject to additions. *See* 317 U.S. at 496-97. The Court's opinion in *Boyle* can be read as simply setting forth when a "deficiency is due to negligence or intentional disregard" rather than reasonable cause.

We need not fully contemplate the effect *Boyle* had on *Spies* to determine the outcome of this case; we therefore leave that question for another day. Appellant has not established that its failure to file tax returns or deposit withholding taxes was due to reasonable cause and not willful neglect as defined in *Boyle*. Although appellant purports in its appellate briefs that the transactions were founded on the U.S.-Netherlands Tax Treaty, it has not established that its deficiencies were not "due to negligence or intentional disregard of rules and regulations" as contemplated by *Spies*. Indeed, as we explained above, appellant failed to prove that it had any purpose other than avoiding U.S. taxes. *See supra* at 5-10. Because appellant bears the heavy burden of proving that its deficiencies were due to reasonable cause and not willful neglect, we have no basis for concluding that the Tax Court erred in upholding the additions imposed by the IRS.

III. CONCLUSION

For the foregoing reasons, the Tax Court's decision is AFFIRMED.

DEL COMMERCIAL PROPERTIES, INC.,
Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

No. 1887-98

UNITED STATES TAX COURT

December 20, 1999, Filed

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, JUDGE: For 1990 through 1993, respondent determined deficiencies in petitioner's Federal income taxes and additions to tax as follows:

		Additions to Tax	
Year	Deficiency	Sec. 6651(a)(1)	Sec. 6656
1990	$5,823	$1,456	$582
1991	136,238	34,060	13,624
1992	479,445	119,861	47,945
1992	265,732	66,433	26,573

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

After concessions, the issues for decision are whether, under sections 894, 1441, and 1442 and under a treaty between the United States and Canada, interest paid by petitioner is subject to withholding tax and whether petitioner

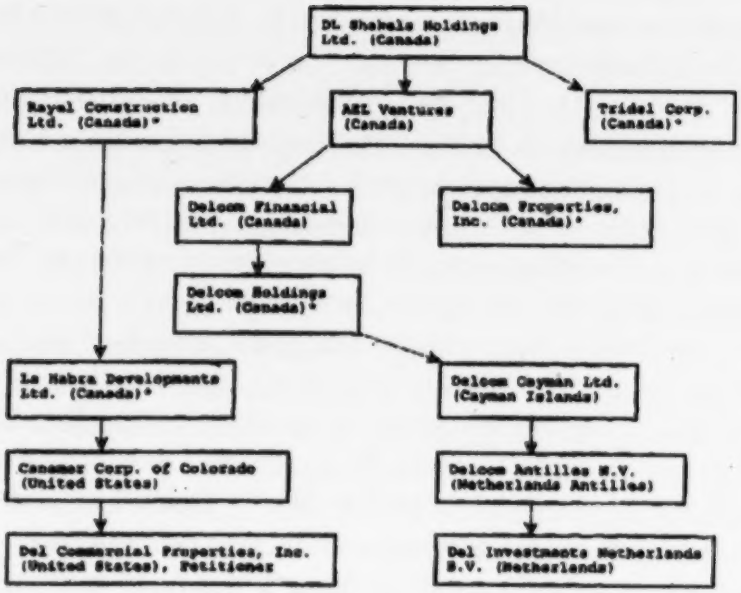
is liable for additions to tax for failure to timely file withholding tax returns and for failure to make deposit of withholding taxes.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

At the time the petition was filed, petitioner's principal place of business was located in Ontario, Canada. Petitioner (Del Commercial) was incorporated in the State of Illinois. Del Commercial invested in and owned industrial real property located in the United States and leased the property to tenants.

In 1990, Del Commercial participated in a series of related and essentially simultaneous financial transactions with a number of its affiliated foreign corporations. As set forth in the chart below, Del Commercial was a fourth-tier subsidiary of the affiliated group of corporations. For each of the affiliated corporations reflected in the chart below, we indicate the name of the corporation and in parentheses the place of incorporation. Unless qualified in the footnote to the chart, each arrow reflects 100- percent ownership and voting control of each lower level corporation.


DL Shabala Holdings Ltd. (Canada)
Rayel Construction Ltd. (Canada)*
AEL Ventures (Canada)
Tridel Corp. (Canada)*
Delcom Financial Ltd. (Canada)
Delcom Properties, Inc. (Canada)*
Delcom Holdings Ltd. (Canada)*
La Habra Developments Ltd. (Canada)*
Delcom Cayman Ltd. (Cayman Islands)
Canamar Corp. of Colorado (United States)
Delcom Antilles N.V. (Netherlands Antilles)
Del Commercial Properties, Inc. (United States), Petitioner
Del Investments Netherlands B.V. (Netherlands)

* With regard to Delcom Properties, Inc., Rayel Construction Ltd., and Tridel Corp., the evidence suggests the possibility of some minority ownership. For 1991 and subsequent years, Rayel Construction Ltd. owned 63.5 percent of La Habra Developments Ltd., and Delcom Holdings Ltd. owned the remaining 36.5 percent.

Tridel Corp. (Tridel) provided overall management and planning for all of the affiliated corporations.

In 1990, Del Commercial needed funds to refinance and to make improvements to some of its real property located in the United States. In order to obtain the necessary funds, officers of Tridel, acting on advice of an accounting firm, initiated and planned the following essentially simultaneous transactions.

On July 18, 1990, the Royal Bank of Canada (Royal Bank), an independent Canadian commercial bank, lent $ 14 million[1] to Delcom Financial Ltd. (Delcom Financial) at an interest rate based on a specified bank prime interest rate plus

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[1] All references to dollars are to U.S. dollars.

one-half percent per annum, payable in 20 approximately equal quarterly installments due in full on July 15, 1995 (Royal Bank loan).

On July 18, 1990, Delcom Financial purportedly made an unsecured loan to Delcom Holdings Ltd. (Delcom Holdings) in the principal amount of $ 14 million at the same bank prime interest rate plus five-eights percent per annum. Delcom Holdings issued a promissory note to Delcom Financial in exchange for the purported loan.

On July 18, 1990, Delcom Holdings purportedly contributed $ 14 million to Delcom Cayman Ltd. (Delcom Cayman) in exchange for common shares of stock in Delcom Cayman. Delcom Cayman then purportedly contributed $ 14 million to Delcom Antilles N.V. (Delcom Antilles) in exchange for common shares of stock in Delcom Antilles, and Delcom Antilles purportedly contributed $ 14 million to Del Investments Netherlands B.V. (Del Netherlands) in exchange for common shares of stock in Del Netherlands. Del Netherlands also executed a written guaranty that guaranteed repayment of the $ 14 million Royal Bank loan.

Del Netherlands maintained a small office in Barbados with one part-time officer who did not have any substantive duties or responsibilities. Other than a few purported loans to members of the affiliated group of corporations, Del Netherlands conducted minimal business activity and had negligible assets and consequently had no independent credit standing outside the affiliated group of corporations.

On July 19, 1990, as an integral part of and dependent upon the above transactions that occurred on July 18, 1990, Del Netherlands purportedly lent $ 14 million to Del Commercial. This purported loan was reflected by a demand promissory note of Del Commercial in favor of Del Netherlands with stated interest at a specified bank prime interest rate plus 1-1/2 percent per annum, payable in 20

quarterly installments and due in full on July 15, 2015.[2] As part of this transaction, a security agreement and a general assignment of rents were entered into between Del Commercial and Del Netherlands.

Also as security for the $ 14 million Royal Bank loan, Del Commercial executed a document labeled "Undertaking" which reflected Del Commercial's obligation to allow Royal Bank to place a mortgage on Del Commercial's real property located in the United States, and it required Del Commercial to provide to Royal Bank annual financial statements, to insure its real property, to assign the insurance policies to Royal Bank, to defer paying dividends to shareholders, and to pay to Royal Bank on the $ 14 million Royal Bank loan proceeds from sale of any of Del Commercial's real property.

On January 1, 1991, Del Commercial began making payments on the $ 14 million loan Del Commercial purportedly had received from Del Netherlands. In each year from 1991 to 1993, Del Commercial made the following total payments on the $ 14 million loan it had received:

Year	Principal	Interest	Total Payments
1991	$28,062	$881,938	$910,000
1992	442,329	3,153,283	3,595,612
1993	866,998	1,683,002	2,550,000

Del Commercial and Del Netherlands recorded the loan payments on their respective books and records as having been made by Del Commercial to Del Netherlands.

For 1991 through June 1992, Del Netherlands transferred the funds received from Del Commercial either to Delcom Holdings or to Delcom Financial. The funds were used to pay principal and interest owed on the $ 14 million Royal Bank loan.

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[2] Del Commercial's promissory note indicates that some interest was to be paid monthly.

In July of 1992, because of concern of Royal Bank over payments due on its $ 14 million loan, Del Commercial began to make the loan payments due on the loan it had purportedly received from Del Netherlands directly to Delcom Financial, bypassing Del Netherlands and Delcom Holdings, and Delcom Financial then forwarded funds to Royal Bank in payment on the Royal Bank loan. On Del Commercial's books and records, those loan payments were still recorded as having been made to Del Netherlands.

On December 4, 1992, Delcom Financial and Royal Bank amended the terms of the original $ 14 million Royal Bank loan. The amendment, among other things, increased the interest rate charged on the loan by 1 percent. Also, under the amended loan agreement, Tridel added its guaranty on the Royal Bank loan.

For 1990 through 1993, Del Commercial did not file U.S. Federal withholding tax returns with respect to the interest payments in issue.

On audit, respondent determined that the substance of the $ 14 million loan to Del Commercial reflected a loan not from Del Netherlands, but from Delcom Financial, and therefore that the interest payments Del Commercial made on the loan should be treated as having been made by Del Commercial to Delcom Financial and as subject to withholding tax.

OPINION

Under section 881(a), foreign corporations which receive interest income from U.S. payors (that is not effectively connected with conduct of a trade or business within the United States) are liable for a tax of 30 percent of the interest received. U.S. taxpayers who pay the interest to the foreign corporations generally are required to withhold the 30-percent tax from interest payments made to the foreign corporations. See secs. 1441 and 1442. U.S. taxpayers who are required to withhold the 30-percent tax and who fail to do so become personally liable for the withholding tax. See sec. 1461.

Under section 894, U.S. treaty provisions may modify the Internal Revenue Code, including the withholding tax provisions. For the years at issue, under a treaty between the United States and Canada (U.S.-Canada Treaty), interest payments made by U.S. taxpayers to Canadian corporations are subject to tax at a rate not exceeding 15 percent if the Canadian corporations are the beneficial recipients and owners of the interest income. See Convention on Taxes on Income and Capital, Sept. 26, 1980, U.S.-Can., art. XI, T.I.A.S. No. 11087.

Also, under a treaty between the United States and the Netherlands (U.S.-Netherlands Treaty), interest payments made by U.S. taxpayers to Netherlands corporations are exempt from tax by the United States. See Supplementary Convention on Taxes on Income and Other Taxes, Dec. 30, 1965, U.S.-Neth., art. VI, 17 U.S.T. 896, 901.

U.S. tax laws and treaties, however, do not recognize as valid for tax purposes sham transactions or transactions that have no economic substance. See *Gregory v. Helvering*, 293 U.S. 465, 470, 79 L. Ed. 596, 55 S. Ct. 266 (1935); *Johansson v. United States*, 336 F.2d 809, 813 (5th Cir. 1964). Even legitimate corporations may engage in sham transactions. See *Knetsch v. United States*, 364 U.S. 361, 366, 5 L. Ed. 2d 128, 81 S. Ct. 132 (1960).

Also, under various applications of the step-transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction. See *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987). A series of steps may be collapsed and treated as one if at the time the first step was entered into there was a binding commitment to undertake the later step (binding-commitment test), if separate steps constitute prearranged parts of a single transaction intended to reach an end result (end-result test), or if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps (mutual-interdependence test). See *id.* at

1429-1430; *Custom Chrome, Inc. v. Commissioner*, T.C. Memo 1998-317, on appeal (9th Cir., Nov. 9, 1998).

We have applied the step-transaction doctrine to disregard the use of intermediaries and conduits for Federal tax purposes. See *Packard v. Commissioner*, 85 T.C. 397, 420 (1985); *D'Angelo Associates, Inc. v. Commissioner*, 70 T.C. 121, 129 (1978); *Gaw v. Commissioner*, T.C. Memo 1995-531, affd. without published opinion 111 F.3d 962 (D.C. Cir. 1997).

Back-to-back loans similar to those involved herein between U.S. corporations and related foreign corporations and between the foreign corporations and their indirect foreign parent corporations have been held to represent mere conduits for the passage of interest payments, and in such situations we have imposed withholding tax liability on the U.S. corporate payors. See *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925, 934 (1971).

Respondent argues that in substance the interest payments in issue made by Del Commercial were paid to Delcom Financial, a Canadian taxpayer, with regard to the $ 14 million Royal Bank loan and therefore that Del Commercial, under the U.S.-Canada Treaty, is liable for a 15-percent withholding tax on the interest payments.

Del Commercial argues that the interest payments were made to Del Netherlands, a Netherlands corporation, and therefore that under the U.S.-Netherlands Treaty the interest payments are exempt from U.S. withholding tax.

Regardless of which theory is used under the step-transaction doctrine, the facts in this case result in the same conclusion. The facts reflect a step transaction created simply to bypass U.S. withholding tax. Del Netherlands had minimal assets, and Del Netherlands had only transitory possession of and no control over the $ 14 million loan proceeds as the proceeds were passed from Delcom Financial to Del Commercial. Apart from the purported $ 14 million loan to

Del Commercial, Del Netherlands engaged in minimal business activity, and the Barbados branch of Del Netherlands had no officer with any substantive duties or responsibilities.

Royal Bank, the independent third-party lender which ultimately provided the $ 14 million, exacted guaranties from Del Commercial and mortgages or deeds of trust on Del Commercial's U.S. real property, establishing the link between the loan payments Del Commercial made and the Royal Bank loan. Del Netherlands passed on the loan payments received from Del Commercial to its affiliated Canadian corporations in order to service the $ 14 million Royal Bank loan. After July of 1992, Del Commercial bypassed Del Netherlands completely and made the loan payments directly to Delcom Financial. Del Netherlands acted as a mere shell or conduit with respect to the interest payments Del Commercial made. In substance, Del Commercial received the $ 14 million loan from Delcom Financial and made the loan payments to Delcom Financial, a Canadian corporation. Del Commercial therefore is liable for the withholding taxes determined by respondent.

Northern Ind. Pub. Serv. Co. v. Commissioner, 105 T.C. 341 (1995), affd. 115 F.3d 506 (7th Cir. 1997), on which Del Commercial relies, is distinguishable. That case involved a loan to a U.S. corporation from a foreign subsidiary corporation using funds obtained from unrelated parties on the Eurobond market. In the transaction at issue in the instant case, the participation of Del Netherlands had no purpose other than avoidance of withholding tax. Even the interest-rate spread that Del Netherlands was to earn was eliminated in 1992 when the interest rate of the Royal Bank loan was increased to 11/2 percent. *Northern Ind. Pub. Serv. Co.* provides no support for Del Commercial.

Under section 6651(a)(1), an addition to tax is imposed for failure to file a tax return, and under section 6656, an addition to tax is imposed for failure to timely deposit a tax due in a Government depository, unless it is shown that such

failures were attributable to reasonable cause and not to willful neglect. Del Commercial has not presented any credible argument that the failure to file and the failure to timely deposit withholding taxes due on interest paid on the $ 14 million loan were attributable to reasonable cause. Respondent's determinations of the additions to tax are sustained.

To reflect the foregoing,

Decision will be entered under Rule 155.

RELEVANT STATUTORY PROVISIONS

26 U.S.C. § 871. Tax on nonresident alien individuals.

(a) Income not connected with United States business—30 percent tax.

(1) Income other than capital gains. Except as provided in subsection (h), there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as—

(a) interest * * *.

* * * *.

26 U.S.C. § 881. Tax on income of foreign corporations not connected with United States business.

(a) Imposition of tax. Except as provided in subsection (c), there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as—

(1) interest * * *.

* * * *.

26 U.S.C. § 894. Income affected by treaty.

(a) Treaty provisions.

(1) In general. The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.

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CONVENTION BETWEEN THE KINGDOM OF THE NETHERLANDS AND THE UNITED STATES OF AMERICA WITH RESPECT TO TAXES ON INCOME AND CERTAIN OTHER TAXES

Entry into Force: 1 December 1948.

Effective Date: 1 January 1947.

Article VIII

1. Interest on bonds, notes, debentures, securities, deposits or any other form of indebtedness (including interest from mortgages or bonds secured by real property) paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State.

2. Paragraph 1 of this Article shall not apply if the recipient of the interest has a permanent establishment in the other Contracting State and the indebtedness giving rise to the interest is effectively connected with the permanent establishment. In such a case, the provisions of Article III shall apply.

3. Where any interest paid by a person to a related person, as defined in Article IV, exceeds a fair and reasonable consideration in respect of the indebtedness for which it is paid, paragraph 1 of this Article shall apply only to so much of the interest as represents such fair and reasonable consideration; the excess payment shall be characterized and taxed according to the laws of each Contracting State, including the provisions of this Convention where applicable.